



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

1100 Commerce
Dallas, Texas 75242

Release Number: **200842046**

July 16, 2008

Release Date: 10/17/08

Legend

XX = Date Address = address

ORG = Organization name

UIL Code: 501.12-01

Person to Contact:

Identification Number:

Contact Telephone Number:

In Reply Refer to: TE/GE Review Staff

EIN:

ORG

ADDRESS

Dear :

This is a Final Adverse Determination as to your exempt status under section 501(c) (12) of the Internal Revenue Code. You have agreed to the revocation of 501(c)(12) status per signing of the Form 6018 on April 11, 20XX.

Our adverse determination was made for the following reasons: Organization is not operating as a voluntary cooperative membership business organization for the benefit of its members. The sale of motto to members on a cooperative basis using their distribution facilities is not similar to a public utility type service.

The ORG fails to meet the requirement for exemption under IRC 501(c) (12). Section 501(c)(12)(A) defines, "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses."

As a result of a recent audit of your organization's activities and Form 990 for the period ended December 31, 20XX, the organization does not meet the requirements under Section 501(c)(12).

Based on the above, we are revoking your organization's exemption from Federal income tax under section 501(c) (12) of the Internal Revenue Code effective January 1, 20XX.

You are required to file Federal income tax returns on Form 1120. You have previously filed all Forms 1120.

You have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call and ask for Taxpayer Advocate assistance.

Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling the Taxpayer Advocate at or writing to:

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

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LEGEND

ORG = Organization name XX = Date XYZ = State motto = motto
County = county City = city REP = Representative CreditCards =
credit cards CO-1, CO-2, CO-3, CO-4 & CO-5 = 1st, 2nd, 3rd, 4th & 5th
companies

ISSUE:

1. Whether ORG is a cooperative exempt from tax pursuant to I.R.C. § 501 (c) (12) for the taxable year 20XX.

FACTS:

ORG (ORG) was incorporated in the State of XYZ in 20XX. From ORG' articles of incorporation, its purposes included:

"(1) Either directly or indirectly, through one or more subsidiary corporations or other entities, to explore for, produce, transport, distribute, market, and sell motto, and to provide services related thereto, for and to its members, or to members of its member corporation or corporations, as the case may be, and other patrons located in the area where the Corporation renders service, and to construct, erect, purchase, lease as lessee and in any manner acquire, own, hold, maintain, operate, sell, dispose of, lease as lessor, exchange or mortgage plants, buildings, machinery, equipment, apparatus, supplies, and transmission and distribution lines or systems necessary, convenient, or useful for carrying out and accomplishing any or all of the foregoing purposes;"

"(4) To assist it's members and members of its member corporation or corporations and other patrons to install lines and on their premises and to install therein appliances, fixtures, machinery, equipment and supplies, of any and all kinds and character and in connection therewith and for such purposes, to purchase, acquire, lease, sell, distribute, install and repair appliances, fixtures, machinery, equipment, apparatus and supplies of any and all kinds of character and to receive, acquire, endorse, pledge, hypothecate and dispose of notes and other evidence of indebtedness;"

"(5) To make available motto, motto, motto, and exploration, production, marketing, sales, transportation, transmission, and distribution facilities and services to other not for profit corporations organized for similar purposes, by sale, lease, or otherwise and to do all such acts and things as may be useful, necessary, or convenient for the accomplishment of the foregoing purposes or any of them;"

The Code of Regulations of ORG. at item 2. (A), provides that "The ORG shall provide motto, motto and motto (hereinafter called "Products, Commodities and Services") to all persons, whether members or non-members, who (1 desire such Products, Commodities and Services

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and (2) meet all requirements established by the ORG as a condition of such service. Conditions of service may be set forth in the rate schedule, Terms and Conditions of Service, policies, rules and regulations of the ORG. No discrimination or preference shall be made between member and non-member patrons of the ORG with respect to rates, prices or terms or conditions of service."

ORG's Business Plan, dated January 20XX (the "Business Plan), at Executive Summary provides that "This is the next stage of business development for ORG. Created in September 20XX, ORG was slated to expand to County and to the remaining general service territory of CO-1 beginning I 20XX. This complies with the original goal of being eventually able to provide service to all members of CO-1." "The Expansion plan involves adding a bulk facility in the City area, preferably at the proposed New City office and warehouse for CO-1. If this isn't possible at the appropriate timer then another location for the tank will be obtained, possibly near City and the new subdivisions that will be receiving piped motto service. This will allow consolidation and sharing of costs and expenses, which will, in turn, help keep the costs of motto down for members."

"The expansion is based on a slow, controlled growth rate in order to maintain excellent customer service and controlled management of operations. Additional personnel for the expansion includes an additional truck driver/installer to help service the new territory and the part-time services (as required) of one of CO-1's Member Service Representatives to help with the new customer growth. Due to the different demographical makeup of the customer base in this area, several marketing approaches will be pursued to attain the desired growth rate."

The Business Plan section entitled Company Overview, provides that ~Mission. ORG, dedicate to providing competitive, stable motto prices with responsive, personal service to maximize member value and improve the quality of life for our members and the community."

~Goals and Objectives. ORG is continuing with the goals and objectives originally developed in the Business, Marketing & Management Plan of June 25, 20XX. ORG intends to grow the business moderately each year, projecting a new total customer base of about 400 customers in 20XX, with slightly lower members in the following years. This will allow the company to serve the community by providing consistent, reliable service with competitive prices, while maintaining needed profit margins and maintaining customer service equal to expectations.

"Location. ORG maintained a sphere of operation in County and surrounding townships that enabled the company to maintain low transportation costs, thereby obtaining needed profit margins in order to grow the business, yet still remain competitive. It's imperative to maintain financial ratios that fall in line with the financial policies of the Co-op as well as those required by the loan company {CO-2})."

"The expansion plan calls for the installation of a gallon bulk storage tank and tank yard, preferably in the proposed new City office location. Another alternative will be to install

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the new bulk tank at a location near City, where new development will incorporate piped motto from the company. This will help keep transportation costs down. Delivery operations can also be routed out of the bulk facility near City, though this will somewhat increase transportation costs."

The Business Plan section entitled Industry and Market Analysis, provides that "Marketplace Analysis. The target for expansion includes the general service territory for CO-1 in City, County, County, and County counties. This would supply as estimated potential market of households within the CO-1 member base. This is based upon a 38.5% motto usage for the southern portion of CO-1 service territory."

"Because motto service is also offered to nonCO-1 members as well f we estimate it is possible that ORG could acquire an additional 2,500 customers in the same townships if the company achieved a 20% market penetration. This penetration may also be possible given the fact that ORG is offering metered motto service - a service that is not currently offered by any competing motto company in the area." "Another factor weighing heavily in the company's favor is that ORG currently obtains 30% of its new customers from new construction. And with County being the fastest growing county in the U. S., this offers many growth opportunities.

The business plan section entitled Marketing Strategy, provides that "Product/Service. ORG offers metered motto service, something that is currently not available by any of the motto competitors in this area. This allows customers the value of paying monthly for only the motto they use that month, and thereby leveling payments and making it more affordable, even if they have no motto usage history. (Motto usage history is required by most competitors to be eligible for the budget billing.) Offering metered motto service will also allow ORG to use -gallow tanks at customer locations as a "storage facility" thereby expanding the storage capacity to better meet peak demand and decrease transportation costs."

"ORG offers metered, keep full and will call motto delivery service, price protection and pre-buy programs, and a variety of payment plans including combined billing, monthly billing, budget billing, Credit Cards card payments, automatic bank draft ad online bill payment."

"Special price protection and pre-buy programs are offered typically in July and August. The price protection program allows customers to lock-in a specific price cap. This allows ORG to safely meet desired margins. ORG will also offer the sale of standard above-ground tanks and underground tanks to round out the product offering. Sales of complimentary products, such as motto detectors and carbon monoxide alarms will also be available. tanks are also offered and typically promoted during the summer months. The Business Plan section entitled Operating Plan, provides that "Legal & Regulatory Issues. Delivery of motto is a tax- exempt co-op business activity under section 501 (c) (12) of the tax code, effective September 28,

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19XX. However, ORG has been declared a Sub Chapter T company. The primary effect of this change is that the company would be required to pay 20% of its margins to members in cash."

"Meter Reading. Meter reading is done by CO-3, which is the same company that is contracted to read CO-1 meters. This incurs a meter reading cost of just ¢ per meter."

In a letter dated March 25, 20XX ORG received exemption as an organization described in § 501 (c) (12) of the Internal Revenue Code. For the first year of operation ORG filed Form 990, Return of Organization Exempt From Income Tax for a shorten period from September 1 to December 31, 20XX. This same return was filed for the calendar year of 20XX. For the calendar years 20XX, 20XX & 20XX ORG has filed Form 1120, U. S. Corporation Income Tax Return.

LAW:

I.R.C. § 501 (c) (12 (A) includes, "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sale purpose of meeting losses and expenses."

I.R.C. § 501(c) (12(B) provides, " In the case of a mutual or cooperative telephone company subparagraph (A) shall be applied without taking into account any income received or accrued - (i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company, (ii) from qualified pole rentals, (iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company, or (iv) from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987)

I.R.C. § 501(c) (12(C) provides, "In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied

without taking into account any income received or accrued -(i) from qualified pole rentals, or (ii) from any provision or sale of electric energy transmission services or ancillary services if such services are provided on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by FERC or under an independent transmission provider agreement approved or accepted by FERC (other than income received or accrued directly or indirectly from a member), (iii) from the provision or sale of electric energy distribution services or ancillary services if such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the mutual or electric cooperative company -(I) to end-users who are served by distribution facilities not owned by such company or any of its members (other than income received or accrued directly or indirectly from a member), or (II) generated by a generation facility not owned or leased by such company or any

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of its members and which is directly connected to distribution facilities owned by such company or any of its members (other than income received or accrued directly or indirectly from a member), (iv) from any nuclear decommissioning transaction, or (v) from any asset exchange or conversion transaction."

LR.C. § 501(c) (12)(E) provides, "For purposes of subparagraph (C) (ii), the term "FERCH means the Federal Energy Regulatory Commission and references to such term shall be treated as including the Public Utility Commission of Texas with respect to any ERCOT utility (as defined in section 212(k) (2) (B) of the Federal Power Act (16 O.S.C. 824k(k) (2) (B)))." Revenue Ruling 57-420, 1957-2 C.B. 308 described an organization formed to provide and maintain a two-way radio system for the mutual benefit of its members and without profit. The ruling states that the organization is similar to a mutual or cooperative telephone company in that a two-way radio communication system on a mutual basis is an organization whose purpose is similar in nature to a mutual telephone company. The ruling held that the organization is a "like organization" and provided 85% or more of its income is collected from members for the sale purpose of meeting losses and expenses, it is exempt under section 501 (c) (12) of the Code.

Revenue Ruling 65-201, 1965-2 CB 170, (Jan. 01, 1965), describes a nonprofit cooperative organization whose activities consist of selling electrical materials, equipment, and supplies, and furnishing equipment manufacturing, repairing, testing, and other services to its members is not a "like organization" within the meaning of section 501 (c) (12) of the internal Revenue Code of 1954, and therefore does not qualify for exemption' from Federal income tax under that 'section of the Code notwithstanding that its membership is limited to organizations exempt under such section of the Code.

Revenue Ruling 67-265, 1967-2 CB 205, (Jan. 01, 1967) I describes an association which furnishes light and water to its members on a cooperative basis may qualify for exemption from Federal income taxes as a "like organization" under section 501 (c) (12) of the Internal Revenue Code of 1954, provided 85 percent or more of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Revenue Ruling 72-36, 1972-1 C.B. 151, describes certain basic characteristics an organization must have in order to be a cooperative organization described in section 501 (c) (12) (A) of the Code. These characteristics include the following: A cooperative must keep adequate records of each member' s rights and interests in the assets of the organization. A cooperative must not retain more funds than it needs to meet current losses and expenses. The rights and interests of members in the organization's savings must be determined in proportion to their business with the organization. A member's rights and interests may not be forfeited upon the withdrawal or termination of membership. Upon dissolution, gains from the liquidation of assets should be distributed to all current and former members in proportion to the value or quantity of business that each did with the cooperative over the years.

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Rev. Rul. 83-170, 1983-2 C.B. 97, describes a cooperative organization formed to provide cable television service to its members. Membership is required in order to receive cable television service. The Rev. Rul. states that the term "like organization," as used in section 501 (c) (12) of the Code, is applicable only to those mutual or cooperative organizations that are engaged in activities similar in nature to the public utility type of service or business customarily conducted by the specified organizations. The Rev. Rul. notes that cable television corporations are similar in nature to public utilities and concludes that the organization qualifies for exemption from federal income tax as a "like" organization within the meaning of section 501 (c) (12) .

Revenue Ruling 2002-541 I.R.B. 2002-37, 527, (Aug. 301 2002), describes an exempt electric cooperative corporation's distribution and sale of tanked propane by trucks was not a "like organization" activity under Code Sec. 501(c) (12) (A) in connection with the facts provided in the ruling. The distribution and sale of the propane by trucks was not deemed a public utility-type service because the rates charged for tanked propane are not traditionally regulated by either states or the federal government. Moreover, no extensive infrastructure was required. The revenue ruling is effective for tax years beginning after December 31, 2002.

Puget Sound Plywood v. Commissioner, 44 T.C. 305 (1965), acq. 1966-1 C.B. 3, the court stated that an organization must meet certain common law requirements in order to be a cooperative. These common law requirements include: democratic control of the organization by members, the organization operates at cost for the benefit of members, and the contributors of capital to the organization do not control or receive most of the pecuniary benefits of the organizations operations (i.e. subordination of capital).

Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846, 864 (1999), the taxpayer 1 a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries, along with the income from the sale of its gas and soybean facilities, and miscellaneous depreciable business assets classified as "patronage sourced" income. The court ruled that the sale of these assets was closely related to and stemmed from the taxpayer's cooperative enterprise of providing products and services to its patrons and therefore the section 1231 gain and the capital gain were patronage sourced income to the extent of business done with members. In reaching its decision, the court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons". if Pomeroy Cooperative Grain Co. v. United States, 31 T.C. 674 (1958), the U.S. Tax Court held that allocations must represent true patronage dividends to be given an exclusion from gross income. The court went on to say that three prerequisites must be satisfied to exclude patronage dividends from gross income: (1) The allocation must have been made under a pre-existing

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legal obligation, one which existed when the members transacted their business with the cooperative. (2) The allocation must have been made out of profits or income realized from transactions with the particular patrons (members) for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations. (3) The allocations must have been made equitably, so that profits realized from selling merchandise or services to patrons, and profits from marketing products purchased from patrons, were allocated ratably to the particular persons whose patronage created each particular type of profit.

GOVERNMENT'S POSITION:

I.R.C. § 501 (c) (12) provides for the recognition of exemption from Federal income tax of benevolent life insurance associations of a purely local character, mutual ditch. Or irrigation companies, mutual or cooperative telephone companies, or "like organizations;" but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

A cooperative has been traditionally and historically defined as a voluntary, membership business organization that is organized in response to the economic needs of and to perform services for its members, and not to realize monetary gains as a separate legal entity. A cooperative is organized and operated for the benefit of and is democratically controlled by its members. See *Puget Sound Plywood v. Commissioner*, 44 T.C. 305, 308 (1966), acq. 1966-1 C.B. 3. Hence, to qualify for exemption under § 501(c) (12), an organization must be a cooperative and organize and operate s such. *Puget Sound Plywood*, supra, describe the principles that are fundamental to the organization and operation of cooperatives They are: democratic control by the members, (2) operation at cost, and (3)subordination of capital. These principles apply to organizations I.R.C. § 501 (c) (12).

§ 501 (c) (12) of the Code provides for the federal tax exemption of electric cooperatives. It was held in Revenue Ruling 67-265, 1967-1 C.B. 205, that a cooperative organization furnishing heat and light to its members is a "like organization" within the meaning of the statute. The term "like organization," as used in the statute and interpreted by Revenue Ruling 65-201, 1965-2 C.B. 170, is applicable only to those mutual or cooperative organizations which are engaged in activities similar in nature to the benevolent insurance or public utility type of service or business customarily conducted by the organizations specified in I.R.C. § 501 (c) (12).

Revenue Ruling 2002-54, I.R.B. 2002-37, 527, indicates that the definition of "like organization" includes providing public-utility type services. However, the distribution and sale of tanked propane by trucks is not a "like organization" activity and would not be considered an activity embraced by I.R.C. § 501 (c) (12). Since the statute, as interpreted by this Revenue Ruling, clearly does not provide for the consideration to motto then any cooperative

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engaging in the delivery of motto would not qualify for exemption. The ruling also indicates that the effective date is for the taxable years beginning after December 31, 2002.

ORG is not exempt under I.R.C. § 501(c) (12), it is a non-exempt, taxable cooperative. ORG's income would be taxable in the same manner as the income of a taxable corporation but with one exception. The exception is that the income attributable to business done with or for members or patrons is deductible from the income of the cooperative. In order for the income to be "patronage source" and deductible from gross income, the income at issue must be produced by a transaction directly related to the ORG's enterprise so that the transaction facilitates ORG's carrying on of that enterprise. *Farmland Industries, Inc. v. Commissioner*, T.C. Memo 1999-388, 78 T.C.M. 846 (1999). In the case of an electric cooperative, the patronage source income includes the refunds of part of the prices initially paid by members or patrons for electricity service obtained through the cooperative. In order to deduct patronage source income from gross income, an electric cooperative must allocate the patronage source income to the members or patrons in proportion to their patronage. See *Pomeroy Cooperative Grain Company v. Commissioner*, 31 T.C. 674, 685-686 (1958).

ORGANIZATION'S POSITION:

The results of the examination were discussed with REP, your organization's representative. REP indicated that she is in agreement with the examination findings and will recommend the signing for Form 6018-A, Consent to Proposed Action.

CONCLUSION:

ORG ("ORG") is not a cooperative exempt from tax under I.R.C. § 501 (c) (12) for the taxable year beginning January 1, 20XX. A cooperative has been traditionally and historically defined as a voluntary membership business organization that is organized in response to the economic needs of and to perform services for its members, and not to realize monetary gains as a separate legal entity. A cooperative is organized and operated for the benefit of and is democratically controlled by its members.

The sale of motto to members on a ORG basis using your distribution facilities is not a "like organization" activity and is not similar in nature to a public utility type service as contemplated under § 501(c) (12) of the Code. Accordingly, ORG is not a cooperative for Federal income tax purposes and, therefore, is not exempt from taxation under § 501(c) (12) starting January 1, 20XX.

Internal Revenue Service

Department of the Treasury

Date:

XXXXXX

Taxpayer Identification Number:

XX-XXXXXXX

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter revoking your exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Rimerez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope